DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0014
Indiana Sales and Use Tax
For the Tax Years 1996 Through 2000

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ISSUES

I. Equipment Use in "Field Filtering" Waste Oil – Sales and Use Tax Production Exemption.

Authority: IC 6-2.5-1-1 et seq.; IC 6-2.5-5-3(b); General Motors v. Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); 45 IAC 2.2-5-8(f)(3).

Taxpayer argues that the equipment used in "field filtering" oil – both at the time the oil is retrieved from the original supplier and at the time the treated oil is delivered to the ultimate consumer – is entitled to the sales and use tax production exemption.

II. Sales and Use Tax Claim for Taxes by Taxpayer's Predecessor Company.

Authority: IC 6-8.1-9-1(a); 45 IAC 15-9-2(d); Tax Policy Directive 4, 1992; Commissioner's Directive 13, 1989.

Taxpayer maintains that it is entitled to present a refund claim for sales and use taxes paid both by itself and by its predecessor company.

III. Abatement of the Ten-Percent Negligence Claim.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asserts that it is entitled to abatement of the ten-percent negligence penalty assessed at the time of the audit.

STATEMENT OF FACTS

Taxpayer is in the business of buying, processing, and reselling waste petroleum products. Taxpayer acquires the waste oil from various sources, picks up the oil, brings the oil to its on-site facility, and then resells the treated oil to companies which are equipped to burn the treated oil for heating purposes. The sources for the oil include; oil change businesses, equipment repair facilities, and service stations. These sources pay a fee in order to have taxpayer pick up their waste oil. Taxpayer's customers – specially equipped to burn the treated oil – include; asphalt companies, steel mills, paper mills, and electric utilities.

Taxpayer is also engaged in cleaning up, treating, and appropriately disposing of contaminated water and contaminated solids.

In those instances in which the waste oil can eventually be processed and resold, the processing takes place at three different stages. At the point where the waste oil is first picked up, the waste oil is filtered as it is being pumped into taxpayer's transport truck. The partially treated oil is then brought to the taxpayer's facility where it is chemically or heat treated. Taxpayer then transports this treated product to one of its customers where, at the point of delivery, the product is once again filtered.

The audit determined that the activities, occurring immediately before the oil was brought to the on-site facility, were "preproduction" activities. The audit determined that the activities which occurred after the treated oil left the taxpayer's on-site facility were "post-production" activities. Accordingly, the audit concluded that the filtering equipment involved in these "preproduction" and "post-production" activities did not warrant exemption from the sales and use tax. The taxpayer disagreed with that conclusion and filed a protest with the Department of Revenue (Department). An administrative hearing was held, and this Letter of Findings followed.

DISCUSSION

I. Equipment Use in "Field Filtering" Waste Oil – Sales and Use Tax Production Exemption.

Essentially, the audit and the taxpayer disagreed as to the scope of taxpayer's production process. The audit determined that taxpayer's production process began and ended at the taxpayer's on-site facility. Taxpayer maintains that its production activities began with the initial filtering performed at the point where the waste oil is obtained from its suppliers; taxpayer further maintains that the its production activities did not conclude until the treated oil was delivered – and filtered – at the site of one of its customers. Accepting for the moment taxpayer's assertions, the field filtering equipment used at the point where the waste oil is picked up and the equipment used at the point where the processed oil is finally delivered to one of its customers, was entitled to the manufacturing exemption.

In Indiana, a sales tax is imposed on retail transactions and a complementary use tax is imposed on tangible personal property that is stored, used, or consumed in the state. IC 6-2.5-1-1 et seq. In this instance, taxpayer invokes one of the exemptions found at IC 6-2.5-5-3(b). The exemption statute reads as follows:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for *direct* use in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (*Emphasis added*).

As used in the exemption statute, the courts have defined the term “processing” to mean, “[A]n operation which places the product in a different, form, composition or character.” Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524 (Ind. 1983). The statutory exemption is applicable to those particular items of processing equipment which constitute “an essential and integral part of an integrated production process.” General Motors v. Dept. of State Revenue, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991). The particular manufacturer’s “production process” is not boundless having a particular point at which the process begins and a particular point at which the process terminates. The tax court has held that, “An integrated production process terminates upon the production of the most marketable finished product, e.g., the product actually marketed.” Id. at 404.

The audit agreed with the taxpayer – and it is not disputed here – that taxpayer is engaged in the “processing” of waste petroleum materials into a product which can be used as heating fuel by its customers.

At the time that taxpayer collects the waste oil from one of its suppliers, the waste oil is filtered using an 800-micron filter. This initial filtering process removes large solids and particulate matter from the used motor oil. This partially treated motor oil is then brought to the taxpayer’s on-site facility where it is treated with heat and/or chemicals for a controlled period of time. Water, which has been separated out of the oil, is then drained away. The partially treated oil is then filtered through a 400-micron filter which eliminates intermediate solids and particulate matter. At this point, the oil is ready for loading into taxpayer’s trucks for delivery to the individual customer’s location. After being transported to the customer’s location and upon final delivery, the oil is then filtered through a 200-micron filter which again reduces the amount of residual solids and particulate matter. At each of the three stages of processing, the oil’s viscosity, water volume, and sediment volume is altered to a measurable and quantifiable degree. All of the processed oil sold by taxpayer undergoes the identical three stages of processing.

The Indiana courts have recognized that exemption statutes, such as IC 6-2.5-5-3(b), are “strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government.” General Motors, 578 N.E.2d at 404. Nonetheless, the exemption should not be construed so narrowly as to defeat the legislative intent expressed within that statute. Id.

The audit erred in concluding that the "field filtering" was not an integral part of the taxpayer's integrated production process on the ground that these activities were pre-processing or post-processing activities. Without undergoing the initial 800-micron filtering stage, the oil would not be ready for introduction into and processing at the taxpayer's on-site facility. Not until the final "field filtering" through the 200-micron filter occurs, is taxpayer's actual end product produced. Absent that final filtering process, the taxpayer has not produced its actual end product. If the taxpayer would attempt to sell semi-treated oil to one of its customers, which had not undergone the final stage of filtering, the oil would not be suitable because it could not be burned. Any attempt to burn the partially treated oil would clog the customer's fuel burning equipment. However, it should be noted that this determination does not permit a conclusion that filtering activities – standing alone – constitute an exempt activity IC 6-2.5-5-3(b).

In addition, any determination as to the taxability of the field filtering equipment, is entirely unrelated to the taxability of the transport trucks on which this equipment is installed. There is no indication that the transport trucks are directly used in the processing of the waste oil; there is no indication that taxpayer's recycling operation constitutes "one continuous integrated production process;" there is no indication that the waste oil constitutes a "work-in-process;" and there is no indication that the transport trucks are in any way exempt from the gross retail and use tax. *See* General Motors, 578 N.E.2d at 404; 45 IAC 2.2-5-8(f)(3).

Accordingly, the Department finds that the taxpayer's field-filtering equipment is entitled to the processing exemption under IC 6-2.5-5-3(b) because the field-filtering equipment is an integral part of the taxpayer's continuous integrated production process during which the form, composition, and character of the waste oil is changed.

FINDING

Taxpayer's protest is sustained.

II. Sales and Use Tax Claim for Taxes by Taxpayer's Predecessor Company.

At the time of the original audit, taxpayer submitted a request for refund of 1996-1999 sales and use taxes paid in error. The audit, and the subsequent investigation, evaluated the claim for refund, and declined to consider the request for refund for failure to meet the proper filing requirements. The audit concluded that the claim for refund lacked documentation necessary to support the dollar amounts claimed.

In its protest, taxpayer now argues that it is entitled to make the claim for refund on behalf of its predecessor company. However, taxpayer oversimplifies the issues surrounding the unresolved refund claim. The audit declined to consider the refund claim for those purchases made during 1996 and 1997 on the ground that the taxpayer could not assert a claim for refund on behalf of another entity. The claim for refund for purchases, made during 1998 and 1999, was denied on entirely separate grounds.

As to taxpayer's first argument, the relevant statute is found at IC 6-8.1-9-1(a) which states as follows: "If a person has paid more tax than the person determines is legally due for a particular taxable period, the person may file a claim for refund with the department." The issue, relevant only to the 1996 and 1997 refund claim, was whether taxpayer, as the predecessor company, was the same "person" as the predecessor company.

Information contained within the audit investigation indicates that taxpayer was incorporated in August of 1997 and became an Indiana "Registered Retail Merchant" in that same month. The investigation concluded that, in reference to taxpayer's 1996 and 1997 refund claim, the 1996 and 1997 taxes were paid on purchases "made by another taxpayer entity."

Under IC 6-8.1-9-1(a), if taxpayer is the same "person" as the predecessor company which originally paid the 1996 and 1997 taxes, it is clearly entitled to present the claim for refund. If, on the other hand, taxpayer simply acquired the physical assets or the trade name of the predecessor company, it is not the same "person" and is not entitled to assert the claim. From the available information, the only thing which is certain, is that taxpayer sprang into corporate existence on August 4, 1997, and that taxpayer and the predecessor share similar names.

However, the issue is not resolved simply on a determination of corporate identity. The Department requires that any entity making a claim for refund, supply information adequate to assess the validity of the claim. 45 IAC 15-9-2(d) requires as follows:

> When filing a claim for refund with the Department the taxpayer's claim shall set forth: (1) the amount of refund claimed; (2) *a sufficiently detailed explanation of the basis of the claim such that the department may determine its correctness*; (3) the tax period for which the overpayment is claimed; and (4) the year and date the overpayment was made. (*Emphasis added*). *See also* Tax Policy Directive 4, 1992; Commissioner's Directive 13, 1989.

The Department's initial response to the taxpayer's claim for refund was that there was "insufficient detail . . . to accurately review and evaluate the taxpayer's basis upon which the refund amounts per vendor were claimed." Requests to the taxpayer for further information resulted in "the auditor being furnished with an incomplete listing of the invoices upon which the claim was based." According to the audit report, the taxpayer was able to supply information substantiating 49 percent of the amount claimed for 1996, 11 percent of the amount claimed for 1997, 29 percent of the amount claimed for 1998, and 0 percent of the amount claimed for 1999. In addition, the audit reported difficulties in reconciling the amounts contained within the information supplied by the taxpayer with the amount presented on the claim for refund form.

During the administrative protest hearing, taxpayer resubmitted the refund claim for 1996 through 1999 taxes along with an explanation for the basis of the claim. At that time, taxpayer requested that the refund claim be considered as part of its protest "because the issues involved in the refund claim [were] identical to those in the protest." To a limited extent, taxpayer is correct; the *basis* for the refund claim apparently raises issues similar to those addressed within part I of this Letter of Findings. However, there is simply no basis for the Department, at this time, to ignore the conclusions reached by the audit investigation and to unilaterally "grant" taxpayer's request for refund. Under IC 6-8.1-9-1(a), taxpayer is required to demonstrate that it is the same "person" as the predecessor corporation which paid the 1996 and 1997 taxes. Under 45 IAC 15-9-2(d), taxpayer is required to submit "a sufficiently detailed explanation of the basis of the claim such that the department may determine its correctness."

FINDING

Taxpayer protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Claim.

Taxpayer asks that the Department exercise its discretion to abate the ten-percent negligence penalty imposed at the time of the original audit.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Besides the filtering equipment addressed in Part I of this Letter of Findings, the audit determined that taxpayer – inter alia – failed to pay sales and use tax for non-exempt leases, machinery, tools, equipment, fuel, chemicals, containers, and clothing. Taxpayer's bare assertion that it "demonstrated reasonable cause for the Department to waive the negligence penalty" is insufficient to establish that it exercised the "ordinary business care and prudence" required of an "ordinary reasonable taxpayer."

FINDING

Taxpayer's protest is respectfully denied.

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